In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 72-1601

N. C. FREED COMPANY, INC., PETITIONER

v.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 7a) is reported at 473 F. 2d 1210. The opinion of the district court (Pet. App. 1a) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on February 1, 1973 (Pet. App. 21a-22a). On April 18, 1973, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to June 1, 1973. The petition was filed on May 30, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Whether the Federal Reserve Board exceeded its rulemaking authority under the Truth-in-Lending Act by promulgating a regulation defining the class of consumer credit transactions giving rise to a three-day right of recission under the Act as including any consumer credit transaction (other than a purchase-money first mortgage) which results or may result in the creation, by operation of law, of a security interest in the customer's principal place of residence in favor of persons who are not creditors under the contract.

STATUTES AND REGULATIONS INVOLVED

Section 125(a) of the Consumer Credit Protection Act ("the Truth-in-Lending Act"), 15 U.S.C. 1635(a), is set forth at pages 3-4 of the petition. Regulation Z, 12 C.F.R. 226.2 and 226.9, is set forth at page 5 of the petition. In addition, Section 105 of the Act, 15 U.S.C. 1604, provides:

> *Rules and Regulations.*
>
> The Board shall prescribe regulations to carry out the purposes of this subchapter. These regulations may contain such classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

STATEMENT

Section 125(a) of the Consumer Credit Protection Act ("the Truth-in-Lending Act"), 15 U.S.C. 1635(a),

grants a three-day right of recission to any homeowner who enters into any credit transaction (other than a purchase-money first mortgage) "* * * in which a security interest is retained or acquired in any real property which is used or is expected to be used as the residence of the person to whom credit is extended * * *." Regulation Z, promulgated by the Federal Reserve Board, which administers the Act, defines the class of consumer credit transactions giving rise to the three-day right of recission as including "* * * any credit transaction in which a security interest is or will be retained or acquired in any real property which is used or is expected to be used as the principal residence of the customer * * *." 12 C.F.R. 226.9(a). The term "security interest", which is not defined in the statute, is defined in another section of Regulation Z as including mechanic's, materialmen's, artisan's and other similar liens and "any lien on property arising by operation of law." 12 C.F.R. 226.2(z).

Petitioner, a company in the home improvement business, brought this action in the district court against the Board and the Federal Trade Commission to declare 12 C.F.R. 226.9(a) invalid and to enjoin the Commission from enforcing it. Petitioner's business consists almost entirely of arranging credit transactions with homeowners for the renovation and remodeling of their homes. The contracts ordinarily state the price of the work and the credit terms. Petitioner makes all the disclosures concerning the cost of financing required by the Act. Although the homeowner is not required to execute a second mortgage, deed of trust or other security interest in his home at the time he enters into a contract with petitioner, he is required to sign an unsecured promissory note, which petitioner typically discounts with a bank or other financial

institution. Neither petitioner nor the party to whom the promissory note is negotiated retains a security interest in the customer's home. By operation of law in many states, however, including New York, [1] various statutory liens may attach to the customer's place of residence at a subsequent time when the work is commenced (Pet. App. 10a-11a).

As applied to petitioner's business, 12 C.F.R. 226.9(a) would give petitioner's customers a three-day right of recission (and would require petitioner to advise them of this right) even though, at the time of the execution of the contract, petitioner does not obtain any security interest in the homes. The district court accepted petitioner's contention that Section 125(a) of the Truth-in-Lending Act "made rescindable only those contracts which acquired a security interest through a mortgage, deed of trust, or other consensual type lien, and did not include liens which might arise in the future by operation of law" (Pet. App. 5a). The court ruled that 12 C.F.R. 226.9(a) was invalid "in so far as it relates to liens which may come into existence by operation of law after midnight of the third business day following the date of consummation of the credit transaction" (Pet. App. 6a).

The court of appeals reversed unanimously, stating that "the district court relied on a too technical and narrow construction which eviscerates the statute, and which renders consumers susceptible to the very abuses Congress sought to prevent" (Pet. App. 19a). The court of appeals further ruled that "[t]he challenged regulation constitutes a clarification, and not an improper extension, of the statute and it therefore does not exceed

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[1] See N.Y. Lien Law, Section 3.

the bounds of the mandate given the Board by Congress" (Pet. App. 19a).

ARGUMENT

The decision of the court of appeals is correct and in full accord with the principles governing the Truth-in-Lending Act recently enunciated by this Court in *Mourning* v. *Family Publications Service, Inc.*, No. 71-829, decided April 24, 1973. There is no conflict of decisions, and review by this Court is not warranted.

In *Mourning*, this Court set forth the governing principles that determine the validity of regulations of the Federal Reserve Board under the Truth-in-Lending Act. The Court stated that "Congress determined to lay the structure of the Act broadly and to entrust its construction to an agency with the necessary experience and resources to monitor its operation. Section 105 delegated to the Federal Reserve Board broad authority to promulgate regulations necessary to render the Act effective." Slip op. at 8. The Court further stated that Section 105 empowered the Board "to define such classifications as were reasonably necessary to insure that the objectives of the Act were fulfilled, no matter what adroit or unscrupulous practices were employed by those extending credit to consumers." Slip op. at 9. Accordingly, the Court in *Mourning* held that a Board regulation under the Act "will be sustained so long as it is 'reasonably related to the purposes of the enabling legislation.'"[2] Slip op. at 12-13 (quoting

[2] Indeed, as indicated by the Court's quotation of *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, where, as here, an agency is granted exceptionally broad powers to fulfill the objectives of an act through regulation, it may be that nothing short of express statutory limitation or abuse of discretion in finding that a regulation. See *Mourning*, *supra*, slip op. at 13-14.

Thorpe v. *Housing Authority of the City of Durham*, 393 U.S. 268, 280-281). Applying the foregoing principles, the Court in *Mourning* upheld a portion of the Board's Regulation Z commonly referred to as the "Four Installment Rule."

The portion of Regulation Z at issue in the present case is valid under the standards enunciated in *Mourning*. The purpose of Section 125(a) of the Act is to protect a homeowner against the loss of his home or against the creation of a cloud upon the title to his home through his unwitting entry into a transaction which results in the creation of a security interest. Section 125(a) accomplishes this purpose by granting a homeowner the right of recission for three days and requiring the creditor to notify a homeowner of this right.

The portion of Regulation Z at issue here is reasonably related to the foregoing purposes since the protection against the creation of a security interest in one's home would be incomplete if the right of recission and the duty of disclosure were not applied to transactions involving subsequent security interests that would arise by operation of law, as well as those involving the execution of a second mortgage or deed of trust at the time of the original contract. In fact, the need for disclosure may be even more important in the former case. The creation of a consensual lien requires at least some knowledge on the debtor's part, but a debtor may have no awareness that, without any further action on his part, a security interest may be created by operation of law.

But whether or not Section 125(a) applies only to security interests retained or acquired at the time of the execution of the original contract, the Board's

regulation would still be valid since, as the court of appeals noted, "statutory liens do not * * * arise only in the future; they may be retained or acquired at the time the credit transaction is executed" (Pet. App. 16a). As the District of Columbia Circuit stated in sustaining the regulation in *Gardner and North Roofing and Siding Corp.* v. *Board of Governors,* 464 F. 2d 838, 841-842:

> A contract to renovate, remodel or repair a house imports that work will be done by mechanics and artisans and that materials will be furnished in connection with that work. Implicit in the contract, therefore, is a provision that a lien will attach to secure payment for the work and materials. In other words, the statutory provision for mechanic's and materialmen's liens must be taken as a part of the contract.

Contrary to petitioner's contention (Pet. 10-11), the Board's regulation is not inconsistent with the legislative history of the Act. As the court of appeals stated, the legislative history "demonstrates that although Congress was concerned in Section 125(a) *primarily* with abuses flowing from creditor use of *second mortgages* as a security device, it was equally concerned with abuses stemming from use of other types of liens" (Pet. App. 14a-15a; emphasis in the original).[3]

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[3]The court of appeals also noted (Pet. App. 19a, n. 23) that the statement of Congressman Cahill, upon which petitioner relies (Pet. 10), was written one year after enactment of the Act and thus is entitled to little weight in construing the Act. Similarly, the Board's efforts to seek legislative clarification of Section 125(a) does not, contrary to petitioner's implied contention (Pet. 11), foreclose the Board from construing the existing statute broadly to effectuate its remedial purposes. See, *e.g., American Trucking Associations* v. *Atchison, T. & S.F. Ry. Co.,* 387 U.S. 397.

Petitioner also contends (Pet. 11-12) that the Act must be given a "strict construction" and the Board's powers must be "read with particular stringency" since criminal penalties are potentially involved. As this Court pointed out in *Mourning*, however, where the language of the challenged rule is explicit, there is no risk that a person may be convicted without fair warning and consequently such cases as *Federal Communications Commission* v. *American Broadcasting Company*, 347 U.S. 284, are inapplicable. See *Mourning, supra*, slip op. at 18-19. Petitioner does not deny the explicit nature of the portion of Regulation Z which it challenges here.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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